



32ND FAA Aviation Forecast Conference

Labor & The US Airline Industry

AN INDUSTRY AT ODDS WITH ITSELF & THE UNIVERSE

Presented by: Randy Babbitt
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Airline Industry - A Bizarre World Where Natural and Physical Laws May Not Apply

- ▶ Darwin's Theory – Survival of the Fittest
 - This one just doesn't work in the airline industry
 - Four of the "big six" airlines filed for bankruptcy since 2002 and none have failed (or will fail)
 - The weak don't die, they just make the rest of the herd sick too.

- ▶ Newton's First Law of Motion: "Objects in Motion Tend to Remain in Motion"
 - Bad news... this one's not at work in this industry
 - Airlines are relying on the assumption that pricing power will continue to grow, even as the economy weakens and threatens profitability again in 2007, and nothing supports that notion

Airline Industry - A Bizarre World

Where Natural and Physical Laws May Not Apply (cont'd)

- ▶ Newton's Third Law of Motion: For every action there is an equal and opposite reaction
 - With significant reductions in costs... income should rise, no?
 - Well, despite a 22% reduction in employees, huge pay and benefits reductions for those remaining, and record passenger traffic, airlines can't seem to push their way to a position of sustainable profitability
 - Look for the "equal and opposite reaction" to be pushback by labor

- ▶ Newton's First Law of Motion (corollary): An object at rest tends to remain at rest
 - Marginally profitable, highly leveraged companies aren't likely to be easily pushed by hungry unions
 - Downside industry risks are many amid the hopes of a stronger 2007

Let's Move from the Sanctuary of "Theory" . . .
To the Truthfulness of the "Market Place"

Overview:

A Problem for Which the Only Solution Is Profitability

- ▶ An industry at the foothills of recovery? Again?
- ▶ The Management view of a new labor cost environment?
 - Latest Buzzwords: outsource, productivity, DC plan, shared sacrifice
 - Fuel for the possible resurgence of the network carriers
 - Obstacles remain; fragile industry, high debt, poor operating performance & hungry unions
 - Our friend, the Railway Labor Act? Labor negotiations could drag on for years; suddenly a viable way to keep status quo labor costs

Overview:

A Problem for Which the Only Solution Is Profitability (cont'd)

- ▶ Labor view of the future - a "recovering" environment?
 - Traffic & revenue have recovered and the industry is profitable again
 - What goes up must come down – oil prices will return to historical trends
 - Now it is "payback time" for our sacrifices
 - Frustration at the bargaining table likely as management "uses the bargaining process"

- ▶ Problem – Can service excellence co-exist with weak profits on one side and lower pay and longer hours on the other?

Who's Right?

"For the first time since the late 1990s, union negotiators are going to the table with an economic breeze at their backs."

Dan Reed, 10/3/06 USA Today Article

"Now is as good as it gets. We are at the top of the cycle."

David Bonderman, June 2006

Is This the Recovery?

- ▶ Two consecutive quarters of US industry profits follow six years of losses totaling about \$40 billion
- ▶ The Upside: Near term optimism
 - Airlines are as lean as ever
 - Oil prices are 20% below all-time highs, traffic has recovered to pre-9/11 levels, and fares have finally increased at a steady rate
 - A possible “soft landing” for the economy could support further traction
 - Wall street has forecast a profitable 2007 for the industry

Is This the Recovery? (cont'd)

- ▶ The Downside: Many fundamental drivers of record losses are structural and permanent . . .
 - Oil prices are likely to remain in the \$60 range (unless the soft landing becomes a recession)
 - Industry shocks (War, London, you name it)
 - LCCs as brand leaders are everywhere
 - Internet commoditization of air fares
 - Security hassle factor
 - Increasing Airport and Security costs per passenger

In the Face of These Pressures, Are There Any More Costs to Cut?

- ▶ Labor? Where is the inspiration for labor to further reduce pay & benefits?
 - On the reward side?
 - Stake in the company? Profit sharing? Growth?
 - Little of the above has “panned out”
 - Workers want to keep (and grow) the hourly rate
 - On the threat side? Bankruptcy? Loss of jobs?

- ▶ What is left?
 - Internal efficiencies?
 - Airport costs?
 - Ticketing? The internet – A blessing & a curse

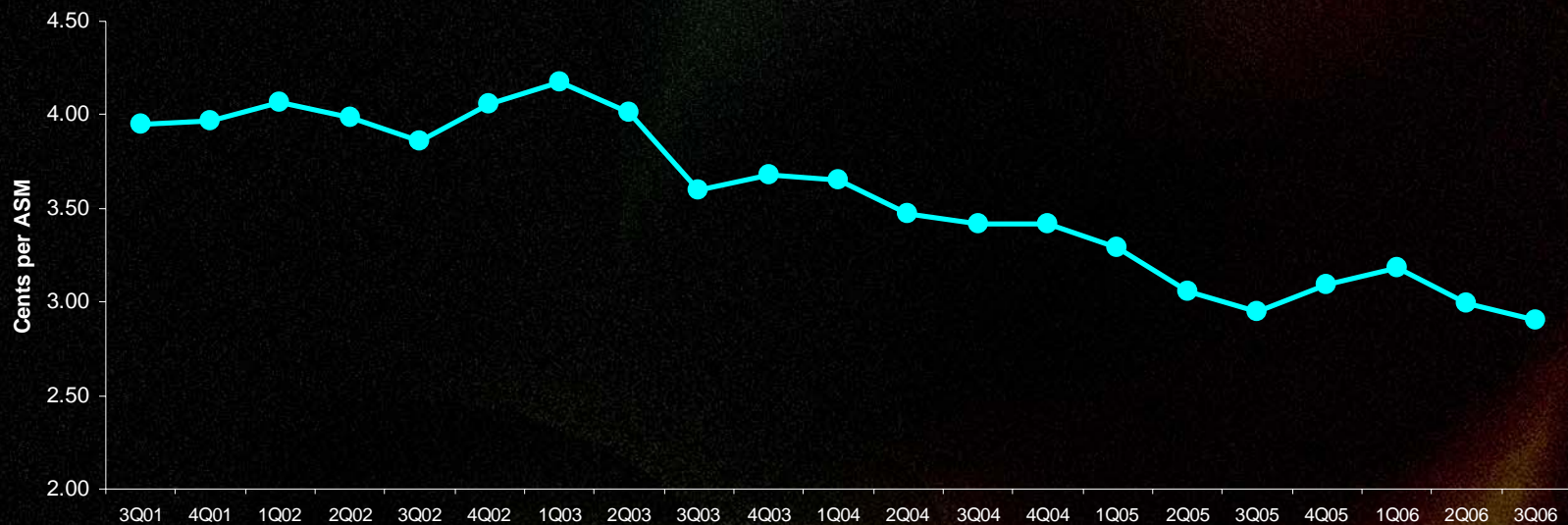
The New Labor Cost Environment

- ▶ Low Cost Carriers – continue to drive costs lower through efficiency and growth
 - Wage & contractual flexibility advantage
 - Longevity advantage – and perpetuated with growth
 - Growth is getting tougher
 - 401(k) pension advantage is a cultural advantage

- ▶ Network Carriers – leaner and meaner
 - New wage & contractual flexibility
 - Pension relief – imposed, legislated or negotiated (Except AS and AA)
 - Expansion potential could be formidable
 - Increased available utilization in crews & aircraft
 - Increased flexibility & block hour production potential
 - Problems - Maintaining morale and customer service levels

Labor Cost per ASM has declined approximately 30% since peaking in early 2003

Labor CASM Growth - All Airlines



Steady State. . . ?

- ▶ AA – restructuring completed in April 2003
 - Company initiated early opener with pilots in 9/2006 to negotiate improved productivity
 - Many business accolades for embracing labor
- ▶ US – final round in October 2004
 - Currently combining HP & US agreements
- ▶ UA –final round in January 2005

Steady State. . . ?

- ▶ CO – restructuring completed in May 2005
- ▶ DL – Pilots closed, others non-union
- ▶ NW – Has deals with all unions

. . . or the Calm Before (Another) Storm?

"After five years of concessionary bargaining, lost pensions, and battered work rules, our pilots are primed to take offensive action. This may mean a return to the hard-nosed tactics of earlier years and a grassroots mobilization of each and every one of our members."

Captain John Prater, New ALPA President

"APA's objectives in Section 6 are slightly more numerous than management's, but they all begin with one primary aim: *we want our money back.*"

Captain Ralph Hunter, APA President

"Profits are up, the share price is up and our members have improved the airline's bottom line by in-sourcing work from other carriers and finding new ways to boost productivity. The gains are there, it's time to share."

James Little, TWU President

Survival of the Fittest Revisited

New Battles in the War Over Labor Costs

- ▶ Some restructured carrier's negotiations are getting between a "rock and a hard place"
 - AA pilots, and US Airways merger agreements set the stage for new contentious battles
 - Companies have not profited and must toe the line on labor costs to remain competitive
 - Workers see a quarterly profit and feel the time has come to "cash in" on their "investments"
- ▶ Bankrupt majors and "Regional LCCs" like Trans States and Mesa have caused a labor cost cascade effect
 - Concessions at Comair, Mesaba are the beginning of regional labor cost spiral at traditional partners
 - Horizon pilots are now amendable and Horizon flight attendants are up in 2007

Survival of the Fittest Revisited

New Battles in the War Over Labor Costs (cont'd)

- ▶ Fall-out from imposed concessions
 - No employee buy-in. Front line employees feel disenfranchised and bitter
 - Every manager's pay is under scrutiny
 - Irrational arguments prevail in a vacuum
 - Tough talk from new labor leadership
 - Lots of "political" analyses are already on the field (Hunter)
- ▶ Successful Company must rebuild the trust while maintaining the focus on cost by creating solutions (i.e. AA-TWU M&E)
 - Constantly engage & educate labor
 - Cooperative plan for the future – Turnaround plan, Go forward plan
 - A tough road, but success will mean a true competitive advantage

Compounding the Problem

- ▶ Belief that “partnerships” never “pay off”
 - Profit Sharing
 - Stock grants or options
 - Performance incentives

- ▶ New Labor Leadership needs to “deliver”
 - Change the direction of the “pattern” in “pattern bargaining”
 - Prove the value of paying to belong to a union
 - New agreements will have to go through the full “process” of negotiations

So Laws Aside, What Is In Store?

- ▶ Labor costs are down – but employees are not out.
 - They are working harder for less
 - They now see themselves as stakeholders and contracts are already entering rounds of contentious negotiations
 - If losses continue, they won't give any more
 - If even small profit, they will want it all back

- ▶ A slowing economy will trump easing oil prices. Fewer passengers and weakening fares will have a more profound impact on the bottom line

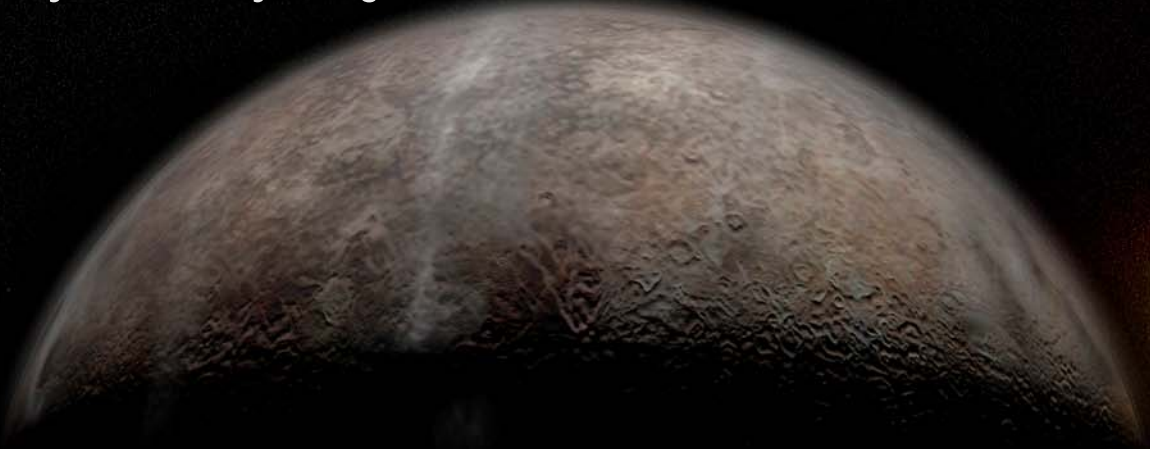
So Laws Aside, What Is In Store? (cont'd)

- ▶ Consolidation is in the pipeline. Another compelling story (like “project barbell”) will draw investors and could take capacity out of the system
- ▶ The declining U.S. dollar could prove detrimental to U.S. carriers who have focused a great deal of carrier growth in international operations
- ▶ With or without a change in “the Age 60” rule, the industry in general is facing a building pilot shortage
 - Military demand and therefore “output” of pilots reduced
 - Incentive to fly professionally now significantly reduced

So Laws Aside, What Is In Store? (cont'd)

- ▶ Will the increase in “hassle factor” really have negative impact?
 - *“Industry revenue production is a function of economic output and fuel prices, not the ability to carry hair gel on one’s person.”*
 - JP Morgan analyst Jamie Baker

- ▶ Pluto... Is the fact we are down to 8 planets going to have a negative impact?
 - Why not, every thing else seems to . . .



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